

III.D.7. Taxpayer Profile

Introduction

In the pre-audit analysis, agents should thoroughly analyze their taxpayer's business and their financial and tax profiles. This will help isolate transactions that are outside a company's core business operations and test them for abusive tax shelter characteristics. (Of course, this should not be read to assume that agents should not test a taxpayer's core business for abusive tax shelters characteristics as well.) For example, questions should be raised when a pharmaceutical company invests in the sale and leaseback of a municipal subway system. Questions may also be raised when a consumer products company enters into partnership with a foreign financial institution to invest significant amounts of money in commercial paper or certificates of deposit.

It is also important for agents to look for significant financial and tax benefits which may motivate the taxpayer to engage in an abusive tax shelter transaction.

Continued on next page

III.D.7. Taxpayer Profile, Continued

Tax Shelter Opportunities

Every taxpayer is unique and its business operations may generate a multitude of tax shelter opportunities. For instance:

1. Taxpayers that sold subsidiaries and incurred a capital gain may be looking for ways to generate a capital loss;
2. Taxpayers that have expiring capital loss or net operating loss carry-forwards may wish to refresh those expiring losses;
3. Taxpayers with capital losses and no currently available offsetting gains, may seek to monetize the capital loss, by converting it to an ordinary loss, which can be offset currently;
4. Taxpayers with excess foreign tax credits may seek ways to convert US source income into foreign source income in order to use these foreign credits;
5. Taxpayers with contingent liabilities such as environmental, product liability, and workmen's compensation may seek ways to accelerate these deductions and also to secure duplicate deductions; and
6. Multinational taxpayers with significant non-subpart F income in foreign subsidiaries and low cash and/or high debt domestically may seek ways to repatriate the cash tax-free.

These are only some examples of the many potential situations for which tax advantages are sought. There are tax shelter promoters who specialize in profiling taxpayers, determining their unique needs to shelter income, and creating shelter transactions tailored to these needs.

Continued on next page

III.D.7. Taxpayer Profile, Continued

Taxpayer's Business

Understanding the taxpayer's business is key to identifying the taxpayer's significant tax characteristics. Agents should review prior-year tax returns for capital loss, net operating loss, and foreign tax credit carryovers. They should also review SEC filings, annual reports, newspaper articles and other publicly available material, noting particularly activities relating to acquisitions and dispositions, reorganizations, and refinancings that took place during the years in question. For example, if the taxpayer sold a subsidiary during the year, the agent should determine whether the taxpayer had a gain or loss on the transaction and where it appears on the return. Note that if the taxpayer sold a business and there is no entry on Schedule D for that sale, the taxpayer may have netted the transaction and further inquiry should be made.

For multinational taxpayers, agents should understand where their cash centers are located. Domestic parents that own controlled foreign corporations with significant amounts of non-subpart F income may have sought tax-free repatriation opportunities.

Taxpayer's Debt Position

Agents should analyze the taxpayer's debt position and compare it to the debt position of the taxpayer's peer group. If it is lower than its peer group, the taxpayer may be disguising debt as equity interests or may be engaging in other types of off-balance-sheet financing that may or may not constitute an abusive tax shelter, but may nevertheless merit further inquiry.

Understanding the taxpayer's traditional risk tolerance is also important. Agents should look at the company's written investment and derivative policies and guidelines, as well as its historical and current actions for indications of its general risk tolerance. If the taxpayer traditionally has a low risk tolerance, a transaction that appears to have significant exposure, for example to interest rates or credit risk, may merit further inquiry, as it may constitute an abusive tax shelter. The taxpayer may have hedged its risk through a separate, but integrated transaction, which is not apparent at first blush.

Continued on next page

III.D.7. Taxpayer Profile, Continued

Comparative Analysis

Finally, agents should do a comparative analysis of the taxpayer's organization charts for the years under examination for at least the prior and subsequent years. Taxpayers frequently utilize special-purpose vehicles, such as partnerships, trusts, newly established corporations, or inactive affiliates to engage in abusive tax shelters. Thus, changes to the organization chart, such as the appearance of new entities, the disappearance of entities, the sale of interests in an entity, or the reorganization of entities within the affiliated group, and /or the transfer of divisions, or sudden increases in balance sheet items of affiliates, particularly previously inactive or newly formed affiliates, may indicate that further inquiry should be made.
